

BEFORE THE
ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company,
American Water Works Company, Inc.,
Thames Water Aqua US Holdings, Inc., and
Thames Water Aqua Holdings GmbH

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Joint Application for Approval of Proposed
Reorganization and Change of Control of
Illinois-American Water Company Pursuant
to Section 7-204 of the Illinois Public
Utilities Act

Docket No. 06-0336

**Supplemental Direct Testimony of
Scott J. Rubin**

*** Omits Information Alleged to be Confidential ***

on behalf of

The People of the State of Illinois

October 26, 2006

1 **Q. Please state your name.**

2 A. My name is Scott J. Rubin.

3 **Q. Did you previously file testimony in this case?**

4 A. Yes, my direct testimony (AG Exhibit 1.0) and exhibits (AG Exhibits 1.01 through 1.11)
5 were filed on August 8, 2006.

6 **Q. What is the purpose of your supplemental testimony?**

7 A. My supplemental testimony will update my direct testimony to reflect information that I
8 received after my direct testimony was prepared.

9 **Q. In your direct testimony, you discuss American Water Works Corporation's**
10 **(AWW) capital program. Do you have any additional information about its planned**
11 **capital expenditures?**

12 A. Yes, I do. Illinois-American Water Company (IAWC) has provided allegedly
13 confidential documents that show a troubling pattern of AWW continually revising its
14 projected capital expenditures. Specifically, in a December 5, 2005, presentation, AWW
15 projected capital expenditures from 2006-2010 of **{begin confidential _____ end**
16 **confidential}**. Two weeks later, on December 20, AWW was projecting capital
17 expenditures for the same five years of **{begin confidential _____ end**
18 **confidential}**. A similar presentation on March 12, 2006, showed capital expenditures
19 for this same period dropping to **{begin confidential _____ end confidential}**. On
20 June 12, 2006, the projection for 2006-2010 had increased somewhat to **{begin**
21 **confidential _____ end confidential}**. In other words, within just a few months,

AWW's capital expenditure estimates have fluctuated by **{begin confidential ____**
end confidential}.

Q. What do these continual changes in projected capital spending indicate to you?

A. It seems that AWW does not have a solid understanding of the level and type of capital spending that it will require over the next five years. This is troubling because most water utility investments take several years to plan, finance, and construct. Historically AWW's operating companies consistently prepared five-year capital plans, so each operating utility and AWW as a whole would have a good idea of the capital spending needs over a reasonable planning horizon. For the capital expenditure number to fluctuate so frequently during a six-month time period certainly makes me wonder whether the same level of diligent capital planning is being conducted at AWW and its operating companies.

Q. How does capital spending in the range of {begin confidential ____
end confidential} compare to AWW's historic level of capital spending?

A. The projected level of capital spending is significantly higher than historic levels of spending. From 2001 through 2005, AWW's capital spending totaled \$2.34 billion ranging from an annual low of \$381 million in 2001 to a high of \$519 million in 2003. The projections of capital spending that are being discussed in these presentations show a marked increase in capital spending for 2006-2010 – **{begin confidential ____**
end confidential} the level of capital expenditures over the previous five years. Further, as I discussed in my direct testimony, AWW projects further large increases (15% per year) in capital spending after 2010.

44 **Q. What is the most recent information you have seen about AWW's capital program?**

45 A. On September 21, 2006, AWW issued a press release in which it described some of its
46 on-going capital projects. That press release (attached as AG Exhibit 2.01) also states
47 that during 2006, AWW expects to spend \$640 million on capital projects. This
48 represents a 24% increase over the level of capital expenditures in 2005.

49 **Q. What do these increases indicate?**

50 A. Increases of this magnitude are fully consistent with indications in the minutes of RWE's
51 board meetings that AWW's infrastructure needs have been neglected, resulting in
52 unacceptably high levels of unaccounted for water and other problems.

53 **Q. Your direct testimony also discusses the under-funding of AWW's pension plan. Do**
54 **you have additional information on that issue?**

55 A. Yes, I have received copies of AWW's annual financial statement for 2005 which
56 provides updated information on its pension plan. In addition, I have received a copy of
57 an actuarial report prepared for AWW's pension plan in August 2006.

58 **Q. What does this more recent information show about the funding levels of AWW's**
59 **pension plan?**

60 A. According to AWW's financial statement for 2005 (relevant portions are attached as AG
61 Exhibit 2.02), as of December 31, 2005, AWW's pension obligation was \$789.1 million,
62 but its pension assets had a value of only \$445.6 million. These figures reflect a
63 worsening of AWW's pension funding status during 2005. As I explained in my direct
64 testimony, at year-end 2004, AWW's pension plan had a benefit obligation of \$704.9
65 million and assets valued at \$427.8 million, a shortfall of \$277.1 million and a funding

ratio of only 60.8%. By year-end 2005, the situation has deteriorated further so that the shortfall increased to \$343.5 million and the funding ratio decreased to only 56.5%.

Q. Does the actuarial study confirm the deterioration in the funding level of AWW's pension plan?

A. Yes, it does. The actuarial study looks at several different measures of the pension plan funding level, not all of which appear in AWW's financial statements. One interesting comparison in the actuarial study is the change in the Accumulated Benefit Obligation (ABO) and the Fair Value of Assets from 2004 through 2006. AG Exhibit 2.03 contains an excerpt from AWW's August 2006 actuarial study that shows the "ABO funded percentage" – that is, the ratio of Fair Value of Assets to the ABO – decreased from 80.8% in 2004 to 67.6% in 2006. This new information confirms the concerns expressed in my direct testimony with the serious under-funding of AWW's pension plan.

Q. In your direct testimony, you stated that AWW projects it will spend \$11 million on the IPO process and \$16 million to comply with Sarbanes Oxley requirements. Has AWW provided updates to these figures?

A. Yes, AWW has increased both of these cost estimates. The latest information I have seen has AWW projecting the IPO-related costs at \$14 million and Sarbanes Oxley costs at \$18.1 million. Documents showing these figures are attached as AG Exhibit 2.04.

84 **Q. Your direct testimony discussed the opinions that credit rating agencies had of**
85 **AWW and the effects of its divestiture from RWE. Is there more current**
86 **information from any of the rating agencies?**

87 A. Yes, on October 13, 2006, Standard & Poor's issued a credit rating for AWW's corporate
88 debt (AG Exhibit 2.05). On October 17, 2006, Moody's issued a rating for AWW's
89 commercial paper (AG Exhibit 2.06). Both credit ratings indicate that the ratings may be
90 revisited when more is known about the proposed separation from RWE.

91 **Q. Your direct testimony discusses the preferred stock that AWW issued to an RWE**
92 **affiliate as part of the initial financing of RWE's purchase of AWW. Have you**
93 **obtained more information about this transaction?**

94 A. Yes, I have been provided with copies of the documents associated with the preferred
95 stock transaction.

96 **Q. Based on your review of the documents, was Goldman Sachs correct when it stated**
97 **that the transaction was guaranteed by AWW's subsidiaries?**

98 A. No, that is not correct. The preferred stock is not guaranteed by IAWC or any other
99 AWW subsidiary. The concerns I expressed regarding the guarantee, therefore, can be
100 disregarded; there is no such guarantee.

101 **Q. Does this affect your concerns with the need to raise \$1.75 billion to redeem the**
102 **preferred stock?**

103 A. No, there is no effect on the financing issue. AWW remains responsible for redeeming
104 the \$1.75 billion in preferred stock if the IPO occurs. It is still unclear whether that
105 amount will be raised from the IPO or from the issuance of new debt.

106 **Q. Does the information you received after your direct testimony was filed lead you to**
107 **change any of your other recommendations?**

108 A. No. With the exception of the preferred stock guarantee issue, the information I received
109 after my direct testimony was filed does not lead me to change my recommendations. I
110 am very concerned about the effects of the proposed IPO on AWW, IAWC, and IAWC's
111 customers. I continue to recommend that the Illinois Commerce Commission impose
112 various conditions on IAWC in order for the proposed transaction to be in the public
113 interest.

114 **Q. Does this conclude your supplemental direct testimony?**

115 A. Yes, it does.